

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D147/01

**Profits tax** – sale of property – intention at the time of acquisition – whether the acquisition of the said property was for the rental yields from the tenancy – whether the acquisition of the said property was to make provision on retirement of shareholder – whether successive sales of the said property indicative of trading intention – whether disposal of the said property within one month of purchase was consistent with an intention to hold the said property on a long-term basis – section 68(4) of the Inland Revenue Ordinance (‘IRO’) – onus of proof on the appellant.

Panel: Ronny Wong Fook Hum SC (chairman), Christopher Chan Wai Hong and Anthony So Chun Kung.

Date of hearing: 29 December 2001.

Date of decision: 30 January 2002.

The appellant is a company with Mr D and Ms C as shareholders. On 5 October 1998, the appellant purchased the said property from Company G subject to its subsisting tenancy in favour of Company H for two years from 1 December 1996 to 30 November 1998. Company G served a notice terminating the tenancy on 1 May 1998 and Company H responded on 21 May 1998 to express an intention to apply for the grant of a new tenancy.

On or about 4 November 1998, the appellant appointed an agent to dispose of the said property and the said property was sold to Company J on 9 November 1998. An application to Lands Tribunal for the grant of a new tenancy was made on 14 November 1998. Company G responded by notice dated 25 November 1998 expressing a willingness to grant a fresh tenancy subject to revised rental.

The sales between Company A, Company G, Company J and Company K were all completed on 2 November 1998. Company A executed the assignment in its capacity as a confirmor. Company J resold the said property six days after the completion on 2 December 1998.

Mr D appeared on behalf of the appellant and gave evidence that the principal justification for acquisition of the said property was the rental yields from the tenancy in favour of Company H and an alleged intention to make provision on the retirement of Mr D. The issue is whether the appellant is liable for profits tax in respect of the gains made via its dealings with the said property.

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### **Held:**

1. The intention of the appellant at the time of acquisition of the said property is crucial in determining whether that flat was acquired as capital asset or trading asset (Simmons v IRC (1980) 53 TC 461 followed).
2. An intention to hold property as capital investment must be definite. The stated intention of the taxpayer is not decisive. Actual intention can only be determined objectively (All Best Wishes Ltd v CIR (1992) 3 HKTC 750 followed).
3. The Board found that as admitted by Mr D, the appellant was merely a shell company at the material times. Its intention could not be divorced from the intention of those persons who were its alter ego. The Board was of the view that Mr D was the moving force behind the appellant and the Board must therefore take cognizance of his intention and ascertain the same having regard to his personal circumstances.
4. The Board accepted that the appellant had no knowledge of the dealings by Company J, but the successive sales of the said property indicated that it was a piece of property hotly in demand with a potential for quick profits to speculators.
5. Mr D admitted that he did not inspect the said property before or after its purchase. He had no knowledge of the history of Company H's tenancy. Within a month of its purchase, the appellant decided to dispose of its interests. These objective facts were not consistent with an intention to hold the said property on a long-term basis. The Board found that the appellant failed to discharge its onus under section 68(4) of the IRO.

### **Appeal dismissed.**

Cases referred to:

Simmons v IRC (1980) 53 TC 461  
All Best Wishes Ltd v CIR (1992) 3 HKTC 750

Cheung Mei Fan for the Commissioner of Inland Revenue.  
Taxpayer represented by its director.

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### **Decision:**

### **Background**

1. The Appellant ('Company A') is a company incorporated in Hong Kong on 28 March 1996. Prior to 16 October 1998, its issued share capital was two shares of \$1 each held by Ms B and Ms C. On 16 October 1998, Ms B transferred the share registered in her name to Mr D. At all material times, Ms C, Mr E and Ms F were the directors of Company A.
2. By a provisional agreement dated 5 October 1998, Company A purchased a flat including the roof and car parking space ('Property 1') from Company G for \$8,380,000. Clause 18 of this provisional agreement provided that Company A agreed to purchase Property 1 subject to its subsisting tenancy ('the Tenancy'). Company H was identified as the tenant paying a monthly rental of \$44,000. Property 1 is of a gross floor area of 1,942 square feet. It was built in 1983.
3. Company A's purchase was pursuant to resolution of its directors passed on the same date. The minutes of that meeting did not state any purpose leading to the acquisition.
4. On or about 16 October 1998, Company A entered into a formal agreement for the purchase of Property 1. Clause 12 of this formal agreement provided that the sale was subject to and with the benefit of the tenancy in favour of Company H for two years from 1 December 1996 to 30 November 1998. Clause 30 of the same agreement provided that Company A was entitled to inspect Property 1 once at reasonable time upon appointment with Company G. Company A was further entitled to a final inspection prior to completion.
5. Company G had in fact served a notice terminating the Tenancy on 1 May 1998. Company H responded on 21 May 1998 expressing an intention to apply for the grant of a new tenancy and making its stay conditional upon the terms of the new grant.
6. On or about 4 November 1998, Company A appointed Company I as its agent to dispose of Property 1.
7. By a provisional agreement dated 9 November 1998, Company A sold Property 1 to Company J for \$10,500,000. According to the minutes of a directors' meeting of Company A held on 16 November 1998, the directors of Company A approved the sale without making any observation on the reasons leading to such sale.
8. By notice dated 14 November 1998, Company H applied to the Lands Tribunal for the grant of a new tenancy. According to this application, Company H had been in possession of

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Property 1 since 10 June 1983. Company G responded by notice dated 25 November 1998 expressing a willingness to grant a fresh tenancy subject to revised rental.

9. By an agreement dated 26 November 1998, Company J onsold Property 1 in favour of Company K for \$11,280,000. The sales between Company A, Company G, Company J and Company K were all completed on 2 November 1998. Company A executed the assignment in its capacity as a confirmor.

10. By a provisional agreement dated 29 December 1998, Company A purchased another flat (Property 2) for \$8,900,000. By a tenancy agreement dated 21 April 1999, Company A let Property 2 in favour of a tenant for two years from 16 May 1999 to 15 May 2001 at a monthly rental of \$35,000 per month. Company A still holds Property 2 at the date of hearing before us.

11. The issue for our determination is whether Company A is liable for profits tax in respect of the gains made via its dealings with Property 1.

### **Pre-hearing correspondence between the Revenue and Company A**

12. By letter dated 30 November 2000, Company A informed the Revenue that:

- (a) 'The original intention is to hold the property for receiving rental income.'
- (b) 'When entering into the provisional sale and purchase agreement to acquire [Property 1], the only information available was the purchase price of HK\$8,380,000 and the monthly rental income of HK\$44,000. As there was a sitting tenant, no physical inspection of the property was allowed.'
- (c) 'After signing the provisional sale and purchase agreement, the Company made further enquiry on the property ... When the Company spoke to the tenant, the tenant advised that the central air-conditioning plant had malfunctions from time to time and there were also water leakages occasionally. They also advised that the wooden floor near the balcony and the bathroom had been loosen and peeled off ... The Company considered that the costs involved to make the property rentable as requested by the tenant would be quite considerable ... the Company considered it better to find a replacement property than to holding the current one.'

13. By letter dated 28 February 2001, Company A maintained that:

- (a) 'As a private company, you cannot expect a very detailed and formal feasibility ... a brief financial analysis revealed that it would give a gross return of

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6.3% which was reasonable for holding properties for rental income.’

- (b) ‘The loans for the acquisition were jointly provided by [Mr D] ... and [Ms C] ... whom are husband and wife.’
- (c) ‘Around 23 October 1998 the Company spoke to the sitting tenant over the telephone to discuss the renewal of the tenancy. It was then that the Company discovered the poor condition of the property.’
- (d) The Company spoke to some contractors and obtained a rough estimate of \$405,000 for removal and installation of the central air-conditioning plant and duct; removal and refixing wooden floor; repainting the whole flat and remedial work for leakage.
- (e) ‘From Form CR 102 the tenant stated that it would renew the tenancy dependent on the terms of the new tenancy. It was later discovered from telephone conversation that the tenant requested a reduction of rental.’

14. By letter dated 26 June 2001, Company A continued to maintain that:

- (a) ‘The original intention is to hold [Property 1] for receiving rental income. This intention has not been changed as the Company is still holding [Property 2] for receiving rental income.’
- (b) ‘For companies that would enter into adventure in trading properties, they normally would require a very long period for completion of the purchase ... Should the company wish to venture into trading, it would not agree to such a completion period which would not give it sufficient time to dispose of the property.’

15. It will be seen from the above summary that the principal justification for acquisition of Property 1 was the rental yields from the tenancy in favour of Company H.

### **The hearing before us**

16. Mr D appeared before us on behalf of Company A. Initially, he gave evidence along the lines as reflected in the correspondence summarised above. He was cross-examined on the rental yields from Property 1. It was put to him that after giving reasonable allowance for market trend the yields from Property 2 did not compare well with that arising from the tenancy in favour of Company H. When pressed Mr D revealed for the first time that the rationale behind the purchase of Property 1 was to make provision in the event of his retirement from Government service. He explained that he is currently enjoying quarters provided by the Government. He does not hold any

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other flat. He purchased Property 1 and Property 2 in order to ensure availability of adequate accommodation on his retirement. He told us that he did not put forward this explanation previously as he wished to avoid any embarrassment arising from his position with the Government.

17. Mr D admitted that despite the complaints by Company H, he did not avail himself the rights conferred on Company A to inspect Property 1. He could shed no light on the truth or otherwise of the alleged complaints of Company H. He conceded that the quotation of \$405,000 was merely a rough estimate on the basis of the area of Property 1. He cannot recall precisely when Company H raised with him the issue in relation to reduction of rental.

18. Mr D laid considerable emphasis on what he regards as a comparatively short lapse of time between 5 October 1998 (the provisional agreement to purchase) and 2 December 1998 (scheduled date for completion) as a pointer against any intention to trade.

### **The law**

19. The intention of Company A at the time of acquisition of Property 1 is crucial in determining whether that flat was acquired as capital asset or trading asset. As stated by Lord Wilberforce in Simmons v IRC (1980) 53 TC 461

*‘Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment?’*

20. An intention to hold property as a capital investment must be definite. The stated intention of the taxpayer is not decisive. Actual intention can only be determined objectively. In All Best Wishes Ltd v CIR (1992) 3 HKTC 750 Mortimer J gave the following guidance:

*‘The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the asset is undoubtedly of very great weight. And if the intention is on the evidence, genuinely held, realistic and realisable, and if all the circumstances show that at the time of the acquisition of the asset, the taxpayer was investing in it, then I agree. But as it is a question of fact, no single test can produce the answer. In particular the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence ... It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including things said and things done. Things said at the time, before and after, and things done at the time, before and after. Often it is rightly said that actions speak louder than words’.*

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21. Under section 68(4) of the IRO, the onus of proving the assessment appealed against is excessive or incorrect is on the appellant.

### **Our decision**

22. As admitted by Mr D, Company A was merely a shell company at the material times. Its intention cannot be divorced from the intention of those persons who were its *alter ego*. We are of the view (and we so find) that Mr D was the moving force behind Company A. We must therefore take cognizance of his intention and ascertain the same having regard to his personal circumstances.

23. We reject the original case of Company A as portrayed in the correspondence. There is force in the Revenue's contention that the rental returns under Property 2's tenancy were not as good as the returns under the tenancy with Company H. It is unclear whether Company H raised the issue of reduction of rental before or after the appointment of Company I on 4 November 1998. It is probable that the force of these points led to the emergence of the new case before us.

24. The new case hinges on an alleged intention to make provision on the retirement of Mr D. We are amazed by its belated disclosure. We do not see why such disclosure should be a source of embarrassment. No legitimate criticism can be levied against a Government servant if he wishes to make provision on his retirement. The need to state the truth must surely be apparent to a person holding Mr D's position. The persistent projection by Company A of a false case counts heavily against the credibility of this new case.

25. We requested Mr D to identify for us the objective facts in support of this new case. Once again, he prayed in aid the period between the date of the provisional agreement and the date of completion as indicative of an intention to hold Property 1 on a long-term basis. We are of the view that only limited weight can be attached to this factor in the particular circumstances of this case. The point can be tested by reference to the position of Company J. Company J acquired its interest in Property 1 under an agreement dated 20 November 1998. That agreement called for completion on 2 December 1998. Company J resold the property six days later. It would be difficult in those circumstances for Company J to contend that there was no intention to trade given the 2 December 1998 completion date. Whilst we accept that Company A had no knowledge of the dealings by Company J, the successive sales of Property 1 indicates to us that it was a piece of property hotly in demand with a potential for quick profits to speculators.

26. Mr D admitted that he did not inspect Property 1 before or after its purchase. He had no knowledge of the history of Company H's tenancy. Within a month of its purchase, Company A decided to dispose of its interests. These objective facts are not consistent with an intention to hold Property 1 on a long-term basis.

27. For these reasons, we are of the view that Company A failed to discharge its onus

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under section 68(4) of the IRO. We dismiss its appeal.